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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE

January 31, 1995

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

Re: Ex Parte Comments
CC Docket No. 94-1
LEC Price Cap Performance Review

Dear Mr. Caton:

MCI hereby replies to an ex parte communication titled "A Proposal for the LEC Price Cap Plan," filed on January 18, 1995, by the United States Telephone Association (USTA). In a Public Notice released January 24, 1995, the Common Carrier Bureau suggested that parties respond to the USTA ex parte by January 31, 1995. MCI opposes the adoption of USTA's proposal. If USTA's methodology were used to set the productivity factor, the resulting productivity offset would be too low. Even if the methodology were corrected, the administrative burden which would result from implementing USTA's proposal would be excessive, and would reduce the local exchange carriers' (LECs)' incentives to control their costs.

I. BACKGROUND

On January 18, 1995, USTA filed an ex parte in the above-captioned docket. In that ex parte presentation, USTA purported to modify its position in this docket, presenting a "comprehensive proposal" which changes USTA's estimate of the required productivity factor, phases out the Consumer Productivity Dividend, replacing it with an annually updated productivity factor, proposes an up-front 1% cut in the price cap indexes, and limits exogenous changes. In addition, USTA proposes that the Commission issue a Further Notice of Proposed Rulemaking, to address additional issues, including modifications to the baskets and bands, treatment of new services, and establishment of a data collection program for all access service providers.

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List A B C D E

II. USTA'S PROPOSAL IS INCONSISTENT WITH THE GOALS OF PRICE CAP REGULATION

In its 1990 decision adopting price cap regulation for the LECs, the Commission discussed at length the purpose, rationale and goals of a price cap regulatory system. Those goals are: (1) generate productivity gains that will be shared with ratepayers by harnessing profit-making incentives; (2) provide an opportunity for the creation of a more economically efficient pricing structure; (3) provide incentives that will encourage innovation; and (4) eliminate burdens in the administration of the tariff process.[1] In the 1994 Notice in this docket, the Commission stated that "the basic goals of price caps remain valid."[2]

In MCI's view, none of USTA's specific proposals, contained in its January 18, 1995 ex parte, furthers any of the Commission's stated goals in this proceeding. As will be discussed in detail below, a plan that includes a four-year average productivity hurdle that is easier on the LECs than the original plan can hardly be said to stimulate productivity growth. In fact, reducing the average productivity offset could easily have the opposite effect -- lower productivity gains than in the first four years of the plan. There is simply no record evidence to support a step backwards for the LECs -- all of the empirical data on productivity, LEC performance, and LEC earnings suggest that the LECs can easily achieve a strong financial showing in the face of a plan that more accurately reflects their true productivity growth.

Nor does the USTA ex parte advance the goal of more efficient pricing for LEC interstate services. Not only would the USTA proposal allow the LECs to set prices higher than they could if the current plan remains in effect, but it would also eliminate all rate structure requirements to maximize the LECs' pricing flexibility. However, USTA has already been told by the

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[1]Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6789-6791 (1990) (LEC Price Cap Order); Price Cap Performance Review for Local Exchange Carriers 9 FCC Rcd 1687, 1692-1693 (1994).

[2]The Commission did, however, refine its goals to include the facilitation of economic growth and the creation of jobs.

Commission that, given current competitive conditions, no additional flexibility will be granted.[3]

USTA again claims that if the Commission is willing to grant the LECs a low productivity offset, the LECs will have the incentive to make "infrastructure investments." In MCI's view, nothing could be further from the truth. The LECs made this same claim in the rate of return docket that concluded in 1990, resulting in an upward adjustment to the Commission's prescribed rate of return.[4] There has been absolutely no change in LEC investment patterns in the intervening years. In fact, LEC investments have focused on offshore and international businesses and not on the public switched network.[5]

Innovation in LEC networks and services should be driven, not by regulatory generosity in the rate-setting process, but by sound public policy. The new services cost support requirements already allow LECs flexibility in pricing new services and allow LECs to reap excessive profits in certain circumstances.[6] In addition, the Commission's pro-competitive policies will help ensure that, over time, LEC decisions about network investment will become increasingly disciplined by market forces. However, granting the LECs freedom to reap monopoly prices from access services and to restructure the pricing of those services will not yield the innovation that the Commission seeks.

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[3]See Expanded Interconnection with Local Telephone Company Facilities, Transport Phase II, CC Docket No. 91-141, Third Report & Order, 9 FCC Rcd 2718, 2731 (1994).

[4]Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, 7530 (1991).

[5]See Letter from Donald F. Evans to William Caton, FCC Secretary, dated January 3, 1995 in CC Docket 94-1; Letter from Leonard Sawicki to William Caton, FCC Secretary, dated September 26, 1994 in CC Docket 94-1.

[6]The new services cost support requirements allow LEC to set their rates equal to direct costs plus reasonable overhead loadings. However, with no requirement to reduce any existing rates to reflect the reduction in the amount of overhead costs which existing services must recover, the LECs will over-recover their overhead costs and reap excessive profits.

Finally, USTA's proposal does nothing to advance the goal of alleviating administrative burdens. USTA takes another step backwards in proposing an annual update in the productivity factor. Is such an update necessary due to large year-to-year swings in productivity? Is it unfair to the LECs to maintain a constant productivity hurdle over a limited number of years? USTA does not discuss these issues, because to discuss them is to answer them. There is no evidence that an annual update in the productivity record is necessary. Yet to adopt such a plan would essentially require the Common Carrier Bureau to undertake an annual access review process that would surpass the former rate of return system in complexity.

In its comments that follow, MCI discusses with greater specificity, the flaws in the USTA plan.

III. A CONTINUALLY UPDATED TOTAL FACTOR PRODUCTIVITY STUDY WOULD HAVE THE SAME DRAWBACKS AS THE RATE OF RETURN SYSTEM

USTA proposes that the productivity factor be updated each year based on a rolling five-year average of the difference between LEC and total economy total factor productivity (TFP). This is an unexplained evolution from the position it adopted in its initial comments, where it stated that the productivity offset should be adjusted only to reflect changes in long-term productivity, where long-term was stated by them to be 8 to 10 years.

USTA also proposes that the LEC TFP should be computed based on the methodology used in the Christensen study filed by the LECs in this proceeding, and the TFP for the total economy would be that computed by the Bureau of Labor Statistics. USTA claims that this moving average could be "generated and verified quickly, easily and mechanically" each year in the annual access tariff filing, and that this mechanism would eliminate the need for frequent reviews of the price cap plan.[7]

MCI does not believe that any TFP study can be performed "quickly, easily, and mechanically." Annual updates of the productivity offset will be based on data provided by the LECs. The current regulatory accounting and reporting systems do not capture the data which is necessary to perform such a study. For instance, the Christensen study notes that "[t]he LECs provided adjustments to the Form M booked revenues" to adjust for the

[7]USTA Proposal, Attachment 1, at 1.

change in accounting in 1988.[8] The Christensen study also relies on Telephone Plant Indexes to compute the capital inputs used.[9] Without Commission rules on how these "adjustments" are to be performed, there is too much opportunity for the LECs to adjust the data to the harm of ratepayers.

Use of a TFP study such as the Christensen study to compute the productivity offset was rejected by the Commission in the original price cap proceeding, which instead relied on two Commission staff studies that examined the productivity performance of the LECs' access services.[10] If the Commission now decides to use a TFP study to set the productivity for LEC access services, it must explain why such a study now gives a more appropriate estimate of the necessary offset.

USTA's proposal is also incompatible with one of the goals of the price cap plan -- reduction of administrative burden on the Commission.[11] It is difficult to see how requiring annual updates of a TFP study achieves that end. Each year, to ensure that ratepayers are being protected, the Commission will have to either perform or review a study which examines changes in LEC inputs and outputs. As part of that study, the Commission will have to examine cost and price data, and determine changes to the quantities of both inputs used and outputs sold. It will have to review adjustments made to the historical data, e.g., the adjustments made to the historical data to adjust for the change to Part 32 accounting. This begins to sound suspiciously like the old rate of return review system, with the added burden of examining 5 years worth of data rather than one.

USTA also claims that adopting its moving-average method will obviate the need for frequent review of the price cap plan, thereby reducing burden. This claim is false; the Commission will be reviewing the price cap plan every year. USTA's proposal will increase the Commission's review of the price cap plan and increase the administrative burden.

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[8]See Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation 1993 Update, attached to the USTA Ex Parte, dated January 20, 1995, at page 6.

[9]Id. at 9.

[10]LEC Price Cap Order at para. 77.

[11]LEC Price Cap Order at para 37.

IV. USTA'S PROPOSAL IS STILL INADEQUATE TO REFLECT THE LECS' TRUE PRODUCTIVITY

Apparently recognizing that the record in this docket supports a much higher productivity factor than the 1.7% it had initially proposed, USTA has now revised its TFP study to increase the average productivity of the LECs since 1984 to 2.1%. USTA is proposing that the Commission adopt a five-year moving average of the LECs' TFP, with a two year lag, as the productivity offset. For the latest five years for which USTA currently has data, this will result in a TFP of 2.6%.[12] In addition to this TFP offset, USTA is proposing for the first year under its plan that there be an additional 1% Consumer Productivity Dividend (CPD) and a 1% up-front one-time cut in the Price Cap Index (PCI). In the second year, there would be a 0.5% CPD, in the third year a 0.25% CPD, and thereafter no CPD, as increases in LEC productivity would be captured in the moving average TFP factor.

MCI has the same objections to this proposal that it had to USTA's initial proposal; the proposed productivity offset is simply inadequate. For the first year the productivity factor would effectively be 4.6% (2.6% TFP plus 1% CPD plus 1% one-time rate cut); in the second year it would be 3.1%; in the third year it would be 2.85%; and every year thereafter it would be 2.6%.[13] The record in this docket shows that LEC productivity has been in the range of 5.5% to 5.9%. USTA's latest proposal, although an improvement over its initial proposal of 1.7%, is still clearly inadequate.

USTA further exacerbates the problems caused by its inadequate productivity offset by proposing the elimination of sharing. Sharing was adopted by the Commission as a backstop mechanism to ensure that the price cap plan did not allow the LECs' access rates to earn at unreasonably high levels. In each year since price caps began, the sharing mechanism has returned a substantial and growing amount of money to ratepayers in the form of reduced rates.[14] Elimination of the sharing mechanism, along with

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[12]This estimate is for the years 1988 through 1992. For the 1995 annual filing, data for 1989 through 1993 would be used. However, economy-wide TFP for 1993 is not yet available.

[13]This assumes that the moving average TFP stays at 2.6%. The data provided by USTA shows that the average TFP has remained fairly constant for the last three years.

[14]This has occurred even though the LECs earnings are depressed each year by the inclusion of the rate reductions due to the prior years' sharing.

the inadequate productivity offset under USTA's proposal, would leave ratepayers with even less protection than they have under the current price cap plan and would result in rates which are unreasonably high.

The LECs have profited quite handsomely under the past four years of the price cap plan with a productivity offset of 3.3%, achieving a rate of return through the third quarter of 13.7%, a full 2.45 percentage points above the rate at which rates were initialized. In 1993, these earnings gave the LECs operating cash flow in excess of $19 billion, while they reinvested only $8.5 billion in their local plant.[15]

USTA's new proposal would give the LECs a productivity offset even lower than the current plan,[16] which will allow them to overearn even more than they already are. In the first year, USTA's proposal will cut rates by only 1.3 percentage points more than the current plan (or $200 million), which will reduce the LECs' rate of return by only about 0.5%. The LECs will still be earning in excess of 13%, in an environment where their cost of capital has fallen to 10%.[17] However, after four years, USTA's price cap plan will have a lower cap than the existing status quo, which will allow their earnings to rise even higher than they are now.

V. THERE ARE SEVERAL IMPLEMENTATION ISSUES THE COMMISSION WILL HAVE TO ADDRESS IF IT ADOPTS THIS PROPOSAL

USTA proposes to use a five-year moving average of LEC TFP to set the productivity factor. USTA states that "[n]o party to this proceeding has a fundamental disagreement with the Christensen methodology for developing the TFP differential."[18] This statement is not true. Numerous parties have noted flaws in the Christensen methodology, noting especially that the Christensen study does not treat input prices consistently.[19]

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[15]See Ex Parte Letter from Donald F. Evans to William F. Caton, FCC Secretary, dated January 3, 1995, filed in CC Docket 94-1.

[16]After 4 years, USTA's proposed productivity offset would reduce the price cap index by less than four years of the 3.3% status quo.

[17]See MCI Comments at 29.

[18]USTA Ex Parte, Attachment 1, page 2.

[19]See, e.g., Reply Comments of Ad Hoc Telecommunications Users Committee, Attachment A at 2. The Christensen study finds that the LECs' input prices have risen at a rate about 2.6% less than the rate for

Correcting this inconsistency alone results in a LEC TFP differential of 5.7%. If the Commission adopts USTA's proposal, it will, at a minimum, have to revise the Christensen study to correct the treatment of input prices.

In addition, as noted supra, there are a number of judgments which anyone doing a TFP study has to make. The LECs themselves have apparently used different judgments at different times regarding both input and output indexes, as evidenced by the change in their estimate of productivity between their originally-filed Christensen study and the current one. Development of any TFP study would embroil the Commission in endless disputes over methodology and data.

In addition to its concerns about the correctness of the methodology, MCI has questions about the relevance of the result of the TFP study. This study, even if done properly, will show only the TFP for the entire range of services which the LECs offer. However, the LEC price cap plan regulates only a portion (although a major portion) of the LECs' interstate access services.[20] If the LECs achieve different levels of productivity in the provision of the various services, as seems likely, the productivity offset for a subset of the LECs' services may be drastically different than their overall productivity.

This appears to be the case here, where even with a productivity offset of 3.3%, the LECs' earnings have continued to rise. The continuing increase in these earnings, reported under a consistent accounting system, indicates that their costs have declined by more than the GNP-PI less the

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input prices in the entire economy. However, in computing the LEC productivity offset, based on this study, USTA neglects to include this input price differential in its computation. This differential must be included in the productivity offset if the price cap is to provide the same incentives that a competitive firm faces, because competitive firms must pass through savings in their input prices.

[20]The Commission has excluded from price cap treatment Individual Case Basis and special construction rates, pre-subscription charges, cable television services, air-ground services, packet switched services, string foreign exchange serving arrangements, and certain LEC offerings to the Federal Government. In addition, LEC price caps regulate the LECs' interstate interexchange services. However, since the cap on those rates uses the 3% productivity offset in the AT&T price cap plan, the TFP differential method under discussion here would not apply to those services.

3.3% productivity offset they have faced under price caps. The LECs' achieved rates of return have grown by about 0.6% per year.[21] This growth alone is worth 1.5 percentage points on the productivity factor.[22]

All analyses of productivity presented in this docket by parties other than the LECs, whether they examine LEC performance under price caps or LECs' TFP since 1984, show that the LECs have achieved a productivity of 5.5% to 6.0%.[23] This level of productivity is also consistent with the LECs' achieved productivity from 1985 until price caps began. Any productivity offset the Commission adopts must recognize these facts.

VI. THE COMMISSION SHOULD REJECT USTA'S ADAPTIVE REGULATION PROPOSAL

In Comments and Reply Comments that USTA initially filed in CC Docket No. 94-1, it urged the Commission to adopt regulatory reform that exceeded the scope of the instant proceeding. That is, rather than focusing on how to improve the price cap tariff review process, USTA advocated broad-scale access structure reform. Specifically, it advanced the USTA Pricing Flexibility Proposal in which it urged the Commission to supplant the current service band indexes with indexes that are associated with geographic markets and are subject to different levels of pricing flexibility depending on market-specific competition levels. Additionally, USTA recommended modifications to the current baskets.

USTA continues to "forum shop{ its proposal for pricing flexibility, long after it has become apparent that the LECs have been told by the Commission that flexibility beyond existing banding arrangements and zone

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[21]This is the case despite the LECs penchant for drastically reducing their reported earnings in the fourth quarter of each year, a phenomenon which has occurred in each year under price caps at a level in excess of the change seen under rate of return.

[22]This does not imply that the Commission need only raise the productivity offset to 4.8%, however. The productivity offset needs to be even higher to capture, among other factors, the decline in the LECs' cost of capital.

[23]See, e.g., AT&T Comments, p. 25; Ad Hoc Telecommunications Users Committee Comments, ETI Report, p. 48.

density pricing plans are sufficient.[24] In Attachment 2 to its January 18, 1995 ex parte presentation, USTA recommends a three phase process to implement "adaptive regulation." Contrary to its position in the earlier Comments, USTA now recognizes that its comprehensive reform plan cannot be addressed in the price cap proceeding. It urges the Commission to implement a few changes in the initial order and simultaneously issue a further notice in which to resolve the remaining issues.[25] Specifically, it recommends that the Commission (1) change the price cap basket structure and banding limits; (2) streamline new service regulation; and (3) establish minimum reporting requirements. For the following reasons, MCI urges the Commission not to adopt USTA's suggestions.

Though USTA does not specify how basket structure and banding limits should be changed, MCI assumes that it continues to support moving the tandem switching function into the switching basket as it earlier proposed. The Commission stated in its Trunking Basket Order, that this modification would allow LECs to combine potentially competitive tandem switching with non-competitive local switching.[26] In order to allow competition to develop in the switching market, it is imperative that LECs be prevented from subsidizing more competitive tandem switching functions with non-competitive local switching revenues. MCI urges the Commission to reject such restructuring.

USTA also states that "DS1 and DS3 subindices should be eliminated to facilitate efficient pricing of substitutable services."[27] This is an issue that the Commission has considered and rejected on numerous occasions, and it should continue to reject it now. The current rate structure is necessary to protect ratepayers, and the Commission only recently reaffirmed it when it extended zone pricing to switched access.[28] MCI

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[24]Expanded Interconnection with Local Telephone Company Facilities, Transport Phase II, CC Docket No. 91-141, Third Report & Order, 9 FCC Rcd 2718 (1994) at 2731.

[25]Attachment 2, p. 1.

[26]Transport Rate Structure and Pricing, CC Docket No. 91-213, Second Report and Order, 9 FCC Rcd 615 (1994) (Trunking Basket Order).

[27]Attachment 2, p. 2.

[28]Expanded Interconnection with Local Telephone Company Facilities, Transport Phase I, Second Report & Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7431-2 (1993), pet. for review

believes that the LECs should savor the ample pricing flexibility that the Commission already has granted them for these services.

With regard to zone pricing, USTA also seeks such flexibility for the local switching category and all elements in the trunking category except the interconnection charge.[29] MCI objects to zone pricing being extended to other services absent a substantial showing that the services are subject to competition. If competition for transport is only just beginning to emerge, competition for switching is not even in sight. LEC interstate access tariffs continue to bundle common line and switching services, and deployment of switches in competitors' networks is in its earliest, nascent stages.

Further, USTA urges the Commission to adopt streamlined regulation for new services. The problem with USTA's proposal, however, is that while it might be appropriate for non-dominant carriers, the LECs continue to exercise market power in the local exchange. The Part 69 access charge rules were created for important public policy reasons that have not yet been supplanted, e.g., to ensure that rates would reflect underlying costs of access service; to promote uniformity for the convenience of interexchange carriers; and to enable the Commission staff to compare rates and costs between LECs for benchmarking purposes. These are just a few of the reasons underlying a prescribed access structure.[30] Moreover, if the Commission were to eliminate the requirement that LECs seek a waiver when they wish to depart from the Part 69 rules, the pro-competitive policies that the Commission has so carefully crafted in the Expanded Interconnection and Transport dockets would be placed at risk.

In addition, the reduced supporting material requirements for the new services test that USTA suggests are far too lax. As the Commission has articulated repeatedly, the new services test is intended to act as a check on both predatory pricing and monopoly pricing. Rates must be set a level that is above the LEC's direct cost, and, while the carrier can recover overhead loadings, those loadings must be reasonable. So long as LECs retain their dominant position in the market it is necessary to retain the current new

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pending sub nom. Bell Atlantic v. FCC, No. 93-1743 (D.C. Cir., filed Nov. 12, 1993).

[29]Attachment 2, p.2.

[30]In MCI's experience, Common Carrier Bureau action on Part 69 waiver requests is generally quite prompt (usually within a few months) in cases involving the addition of optional new elements to the Part 69 structure.

services rules, both to ensure that competition will be given a fair opportunity to develop and to ensure that ratepayers are not forced to pay monopoly prices for those services that are not subject to effective competition.

Nor should the Commission entertain USTA's proposed minimal reporting requirements for all access carriers. As MCI noted in its Reply Comments:

> What the LECs are truly seeking is a low-cost way to target their rate reductions to the individual serving wire centers where competition is beginning to evolve. Such a response would reflect market-based, not cost-based rates, an occurrence which the Commission has rejected before, and it should reject again. Simply put, non-dominant new competitors should not have to list their planned service offering areas. To require such reporting would devastate emerging competition by allowing the dominant LECs to eliminate the CAPs.[31]

USTA's plea for ensuring a framework that is "appropriate for an industry where competition is rapidly growing"[32] is mis-directed. Never before in the history of the Commission's regulation of nondominant, competitive carriers has the Commission affirmatively sought to impose additional burdens on new entrants for the express purpose of "leveling the playing field." The Commission's policy has always been guided by the opposite principle -- when competition is sufficiently developed, regulation of a dominant market player can be eased. The Commission should reject USTA's recommendation.

USTA also recommends that a rate structure be developed "to replace the current Part 69 rate elements."[33] MCI is a proponent of access reform, but it objects to the bias that USTA imparts in its recommended review. That is, MCI believes that it is premature to embark on a re-write of Part 69 elements until the overall access environment is reviewed, and the Commission has identified which problems exist with the current rules that it wants to remedy.[34] A Part 69 reform effort should not begin with the

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[31]MCI Reply Comments, p. 75.

[32]Attachment 2, p. 3.

[33]Attachment 2, p. 3.

[34]See, e.g., Federal Perspectives on Access Charge Reform, A Staff Analysis, released April 30, 1993.

conclusion that rate elements should be eliminated. Instead, a broader review of the access environment is necessary in order to determine the appropriate structure.[35]

In sum, MCI believes that USTA's proposal is beyond the scope of the current price cap docket. In general, its recommendations assume a level of competition in the local exchange that has not developed. Implementation of USTA's plan would serve primarily to ensure that such competition is not able to develop. For these reasons, MCI urges the Commission to address only the issues that relate to the structure of price cap regulation.

VII. CONCLUSION

MCI does not believe the Commission should adopt the proposal made by USTA. Its proposal is at odds with the underlying goals of the proceeding, and it represents a step backwards for the Commission and the LEC industry with respect to the potential ratepayer benefits of a price cap system.

Respectfully submitted,
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[35]MCI agrees with USTA that a review of universal service concerns should be the topic of a separate proceeding.